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TAXATION ON THE TRANSFER OF FARM BUSINESS ASSETS TO FAMILY MEMBERS

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Every farm business, whether a sole proprietorship, partnership or corporation, will some day change ownership. This Factsheet deals with the tax implications of transferring farm assets to family members and the options to minimize tax that farm families have available to them. For information on the sale of farm assets outside the family see OMAFRA Factsheet *Taxation on the Sale of Farm Assets*, Order No. 00-089. For an overview of the succession planning process refer to the OMAFRA Publication 70, *Farm Estate Planning*. Both can be ordered by calling 1-888-466-2372.

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SECTION 1 — THE HUMAN SIDE OF A FARM TRANSFER

COMPONENTS OF CHANGE IN A FARM TRANSFER

A change in farm ownership involves, in many farm families, a significant transition. There are two important aspects in a transition. First, there is the "procedural" dimension dealing with the how, when and what in order to affect the change. This could include tax implications, credit arrangements, business organization, operating agreements, insurance, wills and legal documentation.

The second aspect is the "psychological" dimension and involves the human dynamic. This human dynamic often determines the ultimate success of a family farm business transfer. Components of this dimension includes the meshing of personal family and business goals, the attitude toward change itself, the willingness to let go of ownership, the confidence level in the new ownership in a family farm transfer and the quality of communication among family members.

TRANSITION MANAGER AND TEAM WORK

The objective in a farm business transfer is the realization of personal, family and business goals. Because of the multitude of components an advisory team is essential. The business management advisor can help the family clarify goals, identify alternatives, assist with business and financial planning, and provide an appreciation of the potential tax and legal impact. The accounting and legal advisors can fine-tune the alternatives and implement the decision made by the family.

The most successful farm business transfers usually reveal a strong transition manager who acts like a team captain. Ideally the farm business owner should fill this role and provide the leadership, proper attitude and patience needed for a successful transition in farm ownership.

PERSONAL AND BUSINESS GOALS — THE SOCIAL FACTOR

Before formulating any meaningful transfer plans, it is crucial to identify family and business goals, and clarify and communicate these to all farm family members. Some farm families find this easy to accomplish. Other farm families benefit from the help of professional advisors. Often a business management advisor, who has had good prior communication with a farm family, can provide valuable help in this important area of farm family decision making.

BUSINESS AND PERSONAL FINANCIAL FACTORS

The following 3 criteria contribute greatly to a successful family farm transfer.

Farm Business Viability

The business must be profitable or have potential for profit in order for a farm transfer to take place. It is crucial to determine the financial condition of the business early on in the transfer planning process.

Generosity to Children vs. Personal Needs of Parents

If parents have been successful in their farming career and have had an investment plan, they can afford to be more generous to the child(ren) in both a transfer price and credit terms. However, if parents have considerable cash needs to support themselves and other family members, then they will not be able to be as generous.

Management Ability of Children

The chance of success is greater if the children have gained some management experience. In farming, such valuable experience is often obtained through revenue-sharing arrangements, sharecrop rentals, enterprise separation, partnerships or corporations which delegate some management responsibility.

FINANCING THE TRANSFER

The cash required by parents from a farm transfer has a great impact on the financing arrangements of a transfer. Cash can be borrowed from financial institutions and the child(ren) may assume the parents' debts. Many family farm transfers involve the parents holding a mortgage on the farm real estate and notes or a bill of sale on other assets.

SECTION 2 — METHODS OF TRANSFERRING FARM BUSINESS ASSETS

There are several methods of transferring farm business assets.

BEQUEST

Farming and other assets can be transferred by bequest through an individual's will. The will indicates the wishes of the individual concerning the transfer of business and personal assets should they die before a farm transfer is complete. If certain criteria are met, most farm assets can transfer from parent to child upon death free of immediate tax. Because of this, a will may be regarded as a "contingency" plan until the farm transfer is completed. If death is premature, it will be the transfer vehicle. Some families unfortunately use the will as their primary transfer vehicle and as a result often create a great deal of uncertainty for the farming children. It also prevents them from developing their own succession plans with their children.

GIFTS

Few farmers can afford to give their farms to children. However, some farmers do give individual assets. There is no gift tax in Ontario. The difference between a reduced selling price and the fair market value (FMV) is also a gift free of gift tax. The exception to this is inventory, which is fully taxable in the year of sale.

SALE

The sale of farm assets to family members at their fair market value (FMV) is the same as a sale to anyone else. Normal tax calculations are made. The transfer must be planned to create the desired tax results.

COMBINATION — BEQUEST, GIFT, SALE

The basic concept with most family farm transfers involves selling farm assets at the lowest price parents can afford in order to defer the maximum amount of tax from parent to child. To achieve this, and the other personal and business goals, many farm transfers involve a combination of bequest, gift and sale.

SECTION 3 — INCOME TAX ROLLOVERS AND DEFERRALS

The farm rollover rules are some of the most significant tax planning tools available to farm families to achieve a succession plan. A rollover occurs when farm property is transferred between parties and the resulting capital gain or recapture of capital cost allowance is deferred for income tax purposes. A rollover provides a tax deferral until the asset is eventually sold, when it will be subject to tax calculations. A rollover also allows you to choose the amount of gain that is triggered on an asset that is important for those assets to which the capital gain exemption can be applied.

A ROLLOVER CAN OCCUR WHERE:

- any capital property is transferred from an individual to a spouse while alive or by bequest or to a spousal trust
- farmland and depreciable property, used in the business of farming, is transferred from a parent to a child
- farm assets are transferred to a partnership
- farm assets are transferred to a corporation
- a farm partnership interest or farm corporation share is transferred to a child(ren)
- eligible capital property (i.e. quota) is transferred to a child, while alive, or anyone upon death
- any property received by a child on a rollover basis is transferred back to a parent as a result of the child's death, if so elected.

REQUIREMENTS FOR THE TAX DEFERRAL ROLLOVERS FROM PARENT TO CHILD

In order to qualify for the rollover the eligible property must, before the transfer, be primarily used in farming on a continuous basis by the farmer, the spouse or a child. The transfer may take place while the farmer is alive, or at the time of death. This means that for more than fifty percent of the time of ownership by the transferor, it must be used in farming.

Eligible property must be transferred to a child. Such child may be a daughter, son, grandchild, great grandchild, son-in-law, daughter-in-law, adopted child, step child or their spouses who are resident in Canada. In addition a person who, at any time before the person attained the age of 19 years, was wholly dependent on the taxpayer for support and of whom the taxpayer had, at that time, in law or in fact, the custody and control.

TABLE 1. Summary of Tax Implications of Transferring Assets to Family Members

Type of Asset	Sale Value Within Family	Type of Income Created by Transfer	How it is Taxed.	When is it Taxed.	Options Available to Reduce Tax
Farm Inventory Cash Basis	Transfer at FMV.	Farm income in year payment is received.	Taxed at personal rate for sole proprietors/partner of a partnership. Corporate rate for a corporation.	Added to income and taxed in year payment is received.	Optional & mandatory inventory adjustments and basic herd deductions may be available. Payment may be made over several years using a note or open account.
Farm Inventory Accrual Basis	Transfer at FMV. No deferral.	Farm income in year actually sold.	Same as cash basis — see above	Taxed in year actually sold.	Beginning inventory is a deduction in the year of sale.
Machinery & Equipment- Post 1971 (Part XI)	Transfer at between $0 and FMV but normally between UCC and FMV.	Possible recapture of capital cost allowance that is added to farm income. Possible capital gains.	Recapture of CCA added to income & taxed at personal. 50% of capital gains added to income. No exemption available.	No reserve for recapture. Recapture added to income in year of sale of machinery or equipment.	**Arms Length sale** • Replacement property rules to defer recapture (some cases). • Timing of sale. • Defer recapture by electing to move property from "Classes 2 through 12" into Class 1 before sale. **Within Family**— Transfer at UCC with no tax cost
Buildings Post 1971 (Part XI)	Transfer at between $0 and FMV but normally between UCC and FMV.	Possible recapture of CCA which is added to farm income. Possible capital gains.	Recapture of CCA added to income & taxed at personal. 50% of capital gains added to income.	Recapture is added to income in year of sale.	$500,000 capital gains exemption can be utilized (if available) to offset any capital gains. Capital losses can be deducted against capital gains. Replacement property rules can be used. A capital gains reserve can be used to spread any gain over a 5 or 10 years (in case of sale within family). **Within Family** —Transfer at UCC with no tax cost
Part XVII pre 1972 Machinery, Equipment and Buildings	Transfer at $0 or FMV	No recapture of CCA. Possible capital gains.	50% of capital gains is added to income.	Capital gains are income in year of sale of machinery & equipment. No recapture.	$500,000 capital gains exemption can be utilized (if available) but only for the buildings. For capital gains on buildings, a capital gains reserve could be used to spread any gain over a maximum of 5 years or 10 years if sale within family. **Within Family** — Usually transfer at FMV
Quota or Eligible Capital Property (ECP)	Transfer between $0 and FMV but normally between "4/3 CEC + 1971 Value" and FMV.	Recapture of CCA and farming income that is eligible for the capital gain exemption	See the calculation on page 8.	Taxable in year of sale.	$500,000 capital gains exemption can be utilized (if available) as long as the quota was owned for at least a 24-month period. Replacement property rules can be used to defer capital gains. No AMT is payable on quota. Election can be used to reduce the amount of CPP that would be payable. No reserve available.
Land	Transfer between $0 and FMV but normally between ACB and FMV.	Possible capital gain.	50% of capital gains is added to income.	Taxable in year of sale.	$500,000 capital gains exemption can be utilized (if available). A capital gains reserve can be used to spread any gain over a maximum of 5 years or 10 years a sale within family. Replacement property rules can allow for the deferral of capital gain.
House	Transfer at $0 or FMV (NOT in between).	Capital gain.	Individuals are able to claim a principal residence exemption from capital gains.	Taxable in year of sale.	Use the "principal residence exemption" or the optional method of reducing the total capital gain by $1,000 plus $1,000 per year of ownership for every year the house was used as the principal residence since 1971.
Farm Corporation Shares Partnership Interest	Transfer between $0 and FMV normally between ACB and FMV.	Possible capital gains.	50% of capital gains is added to income.	Taxable in year of sale.	$500,000 capital gains exemption can be utilized (if available). A capital gains reserve can be used to spread any gain over a maximum of 5 years or 10 years a sale within family.

The farmer may own eligible property, either solely or jointly.

Eligible property transferred from an estate must vest indefeasibly with a child, which means it must transfer to the beneficiary within 36 months of death with no strings attached. A longer period may be granted if special circumstances warrant it.

Table 1, on page 3, provides a quick summary of the tax implications of transferring particular assets within the family.

SECTION 4 — TRANSFERS UPON DEATH

In most situations, the dictates of the will determine the tax implications. For transfers by bequest to family members other than a spouse or a child a deemed sale of capital assets at fair market value applies. The same rule applies on a transfer to a child of farm assets that do not meet the criteria and on the assets of a non-farm business.

The income tax act allows a rollover of:

- any capital property by will to a spouse. This can occur at either the FMV or the ACB
- land and Part XI depreciable assets to a child
- a partnership interest or farm corporation shares to a child
- eligible property from a child back to a parent upon the child's death
- quota to any beneficiary
- rights and things like livestock, crops, supplies and accounts receivable to any beneficiary

LIVESTOCK, CROPS, SUPPLIES, ACCOUNTS RECEIVABLE — RIGHTS AND THINGS

Three options are available on death for the farmer filing income tax on a cash basis:

- income can be reported as part of the terminal tax return
- a special separate return can be prepared
- they can rollover to **any beneficiary** deferring taxes until sold by the beneficiary

BUILDINGS, MACHINERY AND EQUIPMENT — DEPRECIABLE CAPITAL PROPERTY

Assets Purchased before 1972, — Part XVII Depreciable Assets

There is no rollover for such assets. They pass to a child at FMV. Such assets are not subject to recapture of capital cost allowance, but can incur a capital gain. For any remaining part XVII buildings the capital gains should be eligible for the full $500,000 capital gain exemption.

Assets Purchased after 1971 — Part XI Depreciable Assets.

A rollover applies for these assets which pass to a child or spouse automatically at their undepreciated capital cost (UCC). The rollover postpones both recapture of UCC and capital gains from the farmer to the child or spouse. Part XI assets passing to other beneficiaries' transfer at FMV. *Table 2* gives some examples.

TABLE 2. Part XI Assets to a Child

	Rollover	Election
FMV – Class 8 Asset	$60,000	$60,000
UCC	30,000	30,000
Rollover at	30,000	Not used
Election	not used	50,000
Recapture	0	20,000

QUOTA — ELIGIBLE CAPITAL PROPERTY

Quota can rollover. A bequest to any person of eligible capital property is deemed to occur at four-thirds (4/3) the undepreciated balance of the "cumulative eligible capital" account (CEC). This results in no income to the deceased person with the beneficiary taking the deceased person's place for future tax calculations. This rollover is available to anyone not just a child.

LAND, A FARM PARTNERSHIP INTEREST AND SHARES IN A FARM FAMILY CORPORATION

Farmland, a farm partnership interest or shares in a farm family corporation incur capital gains when assets pass to anyone other than a child or a spouse. When the above criteria are met, a rollover occurs and the gain is postponed to the child. **However, a legal representative of the deceased may elect between the ACB and FMV in order to incur some gains and provide the child with a higher ACB at no tax cost to the estate if the $500,000 exemption remains.** The alternative minimum tax (AMT) does not apply in the year of death. *Table 3* gives an example.

TABLE 3. Bequest of Land, Shares, Partnership Interest to a Child

	Rollover	Election
FMV	$300,000	$300,000
ACB	100,000	100,000
Assets Rollover at a value of:	100,000	Not used
Elected Value	Not used	300,000
Capital Gain	0	200,000
Taxable Gain	0	100,000
Child's ACB	100,000	300,000

IMPORTANT CONSIDERATIONS

Extra avenues for rollover

Assets could past first to a spouse and then to a child while alive or upon death. The assets eligible for a rollover can also pass to a spousal trust and then to a named child.

Pitfalls which could negate rollovers

Even with the $500,000 capital gain exemption, it is usually better to be eligible for a rollover and elect to trigger the appropriate amount of gain.

- Rental of assets to persons other than children or spouses, for more than 50% of the ownership period negates rollover and deferral.

- A "tainted" spousal trust can negate a rollover. This can occur if the spousal trust breaks certain rules. For example if a spousal trust makes payments to someone other than the spouse it would no longer be a valid spousal trust.

- An obvious beneficiary of a spousal trust must be named. A will leaving land to A if A should outlive the spouse, but to B if A should pre-decease the spouse can negate a rollover.

- Granting of "Options to Purchase" in a will to a child who is likely to farm has created some historic tax problems. While this technique gives the child some assurance of availability at a price such as ACB, the item really transferred is the option rather than the asset. As a result, taxable calculations, in a few cases, were based on full market value. Recent amendments to the *Income Tax Act* have reduced the likelihood of this occurring if both tax advisor and tax auditors are aware of the changes. A better alternative might be to have the farmer bequest an asset to a child and require the child to pay an amount to a sibling or the estate. This provides a tax deferral for the deceased, an asset for the child and a tax-free sum of money for the sibling. The executor could elect to trigger some capital gain to use any available exemption and give the child a higher ACB.

SECTION 5 — TRANSFERS WHILE ALIVE

The *Income Tax Act* allows a farmer to sell assets anywhere between zero (a gift) and the current value. Unfortunately, many people think it must be between the tax cost and the FMV. If the selling price falls between zero and the tax cost, all of the tax liability is deferred. If the selling price falls between the tax cost and current value, part of the tax liability is incurred and part is deferred. If sold for more than the higher of tax cost and FMV, the deemed proceeds and cost equal that higher amount rather than the sale price.

A sale anywhere from zero to FMV is possible but between ACB and FMV is most common. The $500,000 Capital Gain exemption makes it more common to sell for close to FMV. The parent has tax-free proceeds except for possible alternative minimum tax and the child has a higher ACB. To assist with financing the business, the parent may have to charge a low rate of interest to assist with debt servicing. The parent might even forgive a mortgage in his or her will. Holding a mortgage from a child should also qualify as a reserve to spread capital gain over a period of up to 10 years, if needed, to avoid minimum tax.

INVENTORY ITEMS — LIVESTOCK, CROPS AND SUPPLIES

Inventory items are normally transferred at current market value. For the few farmers who file on the accrual basis there will be little tax concern if the beginning inventory values were fairly current. However, the majority of farmers file on the cash basis. For them, the current value of the livestock, crops and supplies will be considered as income no matter what is charged. Thus, the parent normally charges market value. There are two deductions that may apply to some farmers.

- Some older farmers with breeding herds still have basic herd credits that can be deducted from the income.

- Some beef, pork, and crop producers have sizeable optional inventories created in near loss years that can be deducted from income. A few may have mandatory inventory adjustments created in actual loss years to deduct from income.

The timing of the transfer is important. The transfers can sometimes be timed when the inventory of crops and supplies are lowest or it can be spread over several years. This can be accomplished several ways.

- Through informal sharing agreements, the child may buy or receive breeding stock for several years until he has obtained most of the breeding herd.

- In a more formal agreement, the parent may sell the livestock to the child on an "open account" via a simple invoice. Because of the "cash basis", the parent spreads the income over several years as payments are received. The payments will be farm income, eligible for CPP and RRSP contributions.

If the parent and child plan to carry on a partnership or corporation there are several options available. While there is no rollover for inventory from a parent to a child, there is a rollover from a farmer to his partnership or corporation.

- A half interest in inventory items could be transferred to the child. Both the parent and child could then roll into a partnership or corporation.

TABLE 4. Alternative Transfer Prices for Part XI Assets

Today's FMV	Various Family Sale Prices	Cost	UCC	Deemed Proceeds to Parent(s) & Cost to Child	Capital Gain	Re-capture
$25,000[1]	$25,000	$20,000	$12,000	$25,000[1]	$5,000	$8,000
25,000	18,000	20,000	12,000	18,000	0	6,000
25,000	12,000 [2]	20,000	12,000	12,000[2]	0	0
25,000	0	20,000	12,000	12,000	0	0

(1) If we assumed that this was a building and the parent used a capital gain exemption, in this unusual situation, the child's cost of $25,000 will be reduced for CCA purposes by the anti-avoidance rules by the $5,000 capital gain exemption claimed by the parent to $20,000.

(2) Because most parents want to avoid recapture, the UCC is a common sale price.

- Alternately, the parent could elect to roll his/her inventory into a partnership or corporation. Subsequently, the parent could transfer part of a partnership interest or shares to the child. In this manner, inventory with is taxable on sale is changed to an interest or share. If a transfer of the shares or partnership interest to the child is done soon after the rollover to a corporation or a partnership, the capital gain exemption could be blocked under the anti-avoidance rules unless all of the assets are rolled into the new business. A gift of shares or partnership interest on a roll over basis should be okay.

Buildings, Machinery and Equipment — Part XI Assets (purchased after 1971)

In a family transfer the undepreciated capital cost (UCC) is the value that is often used. This is because a value at or below the UCC defers both any capital gain and recapture. A family price above the UCC will incur some re-capture and possibly a capital gain if greater than ACB. *Table 4* above illustrates the results of some alternative family sale prices.

Buildings, Machinery and Equipment — Part XVII Depreciable Assets (purchased pre 1972)

There is no tax deferral for part XVII depreciable assets. They must transfer at their fair market value regardless of the sale price. The deemed proceeds for the parent equal the fair market value while the cost to the child is the amount that was paid. However if the parent transfers them as an outright gift, the child is considered to have paid the FMV.

Most depreciable assets such as equipment have decreased in value and have disappeared since 1971, creating no tax concerns, but for some good buildings, capital gains have accrued since 1971. Again, the rule of thumb is to transfer at either zero or FMV. Because these assets were owned in 1971, the calculations can be more complicated and tax advice should be sought.

Principal Residence

The principle residence must transfer at FMV regardless of the sale price to the child. Like part XVII depreciable assets the deemed proceeds to the parent is considered FMV. This is not a great concern with the principle residence because it is exempt from capital gains. Because the gain is exempt, the family sale price is usually zero or fair market value. The cost to the child is what they paid, however if the house is gifted the child is considered to have paid FMV. *Table 5* below illustrates the results of alternative transfer prices.

TABLE 5. Alternative Transfer Prices for Personal Residence

1971 Value	Today's FMV	Various Transfer Prices	Deemed Proceeds to Parent	Deemed Cost to Child
$25,000	$95,000	$95,000	$95,000	$95,000
25,000	95,000	55,000	95,000	55,000
25,000	95,000	0	95,000	95,000

QUOTA

The tax rules for buying and selling quota are quite complex. Before discussing the implications of a transfer within the family it is helpful to review the tax basics of quota sales.

Depreciating (Amortizing) Quota and Your Cumulative Eligible Capital (CEC) Account

The Canada Customs and Revenue Agency classifies quota as Eligible Capital Property and changes in quota holdings affect your Cumulative Eligible Capital Account or CEC Account. The CEC account is a bookkeeping record that is set up to determine the annual allowance and to keep track of the property that you buy and sell.

Three quarters (75%) of a quota purchase is depreciable, at a rate of 7% annually. The other ¼ of your quota purchase is non-depreciable, and is set aside from tax calculations when the quota is sold. If you bought quota worth $100,000, $75,000 (75%) would be added to your cumulative eligible capital account, and depreciated at a rate of 7% per year, on a declining basis.

Selling Quota to a Third Party

The sale of quota can generate both recapture of depreciation and capital gains. The principle of recapture on quota is similar to that of depreciable property. Recapture occurs when the cumulative eligible capital account falls below zero. When this occurs, a portion of the sale is

recapture and is added to your income, and part is a capital gain. When eligible capital property, such as quota experiences a capital gain, it is called a business income that is eligible for the capital gain exemption. This farming income is eligible for the $500,000 Capital Gains Exemption and is not subject to Alternate Minimum Tax (AMT). *Table 6* shows how the calculation is made.

TABLE 6. Example of Milk Quota Sale

Information you need for the Calculation	
1971 value	$20,000
CEC account balance	$30,000
Depreciation	
Pre '1988	$8,000
Post '1988	$12,000
Calculation	
Gross Sale Value	$350,000
Deduct 1971 value ($20,000)	$330,000
Taxable portion (75%)	$247,500
Deduct CEC ($30,000)	$217,500
Less Recapture (total depreciation)	$20,000
Subtotal	**$197,500**
Less 50% of pre-1988 depreciation	**$4,000**
Equals	$193,500
Calculation of Quota Sale Added to Farming Income	
Quota Sold in Fiscal Period Ending Prior to February 27, 2000	
Amount included in farming income:	**$193,500**
Quota Sold in Fiscal Period Ending between Feb. 27, 2000 and Oct. 17, 2000 at 66 2/3% rate	
8/9th's adjustment results in additional farming income of :	**$172,000**
Quota sold in Fiscal Period Ending after Oct. 18, 2000 at the 50% rate	
2/3 adjustment results in additional farming income of :	**$129,000**

In the example above, $20,000 of recapture is added to the farm income, plus the income from the quota sale.

The $4,000 pre–1988 depreciation adjustment occurs because in 1988 the capital gains inclusion rate was raised from 50% to 75%. Eligible Capital Property Accounts were adjusted by 50% to account for the change in the amount of quota that was now eligible to be depreciated.

Depreciation taken before 1988 however, was not recalculated, so an adjustment is required at the time of sale to reduce the income from the quota sale by 1/2 the pre-1988 depreciation. This is depreciation that is allowed under the post 1988 rules. In this example, the depreciation taken before 1988 is $8,000, so the adjustment is $4,000, which is subtracted from the farming income from the quota sale.

TRANSFERRING QUOTA WITHIN THE FAMILY

An amount equal to 4/3 of the adjusted undepreciated balance of post 1971 quota (CEC) plus the 1971 value, of pre 1972 quota, if applicable, is the highest price that will trigger no income. The formula is **(4/3 x CEC) – 1971 Value**. A sale between this value and FMV will trigger some capital gain or recapture. The 1971 values deducted by the parent reduce the deemed cost to the child. The child's deemed cost is further reduced by 2 times (or 4/2 — this is based on the capital gains inclusion rate 50%) the capital gain exemption claimed by the parent.

The income inclusion on a sale is divided into two. The first is recapture of depreciation that has been previously claimed as an expense. This is added to farm income. The second part is the gain that is considered farming income eligible for the capital gain exemption (if any of the $500,000 exemption is available).

Table 7 on the next page illustrates the results of some alternative family sale prices. The examples assume that all quota was purchased post 1971 and thus the 1971 value deduction is zero. The FMV is $600,000. The adjusted CEC balance is $50,000 and $40,000 of depreciation has been taken, one half pre 1988 and one half post 1987. The parent claims a capital gain exemption.

There is no Alternative Minimum Tax calculation on quota.

Business Structure and Taxation of Quota Sale

The amount of tax on a quota sale depends on how the quota is owned. If the quota is sold by an individual or a partnership, the recaptured $20,000 is taxable income in the year the quota is sold, and taxed at the personal rate of the individual. The income from the gain on the sale of quota qualifies for the capital gains exemption, which can be used if available. Because the gain portion of the quota sale are considered to be farming income that is eligible for capital gains exemption and not a straight capital gain it can mean that CPP must be paid. CCRA allows this gain portion of the quota sale to be treated as non-depreciable capital property and thus avoid the additional CPP payments on that portion

If a corporation sells the quota, 3/4 of the proceeds are subject to tax calculations. The book value of the quota is deducted from these proceeds. The recapture and capital gain is business income in the hands of the corporation, and is eligible for the small business tax rate. A large quota sale could push the corporation's net income above the small business corporate tax rate and into the higher corporate tax rate. If practical the sale could be spread over a number of years.

TABLE 7. Alternative Transfer Prices for Quota (Post 1971)

Various Family Sale Prices	Deemed Proceeds	3/4 Deemed Proceeds	(Deemed Proceeds Less CEC)	Re-capture	Farming Income Eligible for Capital Gain Exemption	Deemed Cost to Child
$600,000	$600,000	$450,000	$400,000	$40,000	$233,333[1]	$133,334[2]
300,000	300,000	225,000	175,000	40,000	83,333	133,334
0	66,666	50,000	0	0	0	66,666

(1) Deemed taxable capital gain = $400,000 – ($40,000 recapture) – (1/2 of $20,000 pre 88 depreciation) = $350,000. Then use a 2/3 adjustment for the 50% inclusion rate, which equals $233,333.

(2) If the parent uses the capital gains exemption the child's tax cost is reduced by 2 times the taxable gain. In the first example this would be 2 x $233,333 = $466,666. This would reduce the child's cost from $600,000 to $133,334 (600,000 – 466,666).

TABLE 8. Alternative Transfer Price for Land

Today's FMV	Various Family Sale Prices	ACB	Deemed Proceeds to the Parent(s) & cost to the child	Capital Gain
$600,000	$600,000	$100,000	$600,000	$500,000
600,000	300,000	100,000	400,000	300,000
600,000	100,000	100,000	100,000	0
600,000	0	100,000	100,000	0

TABLE 9. Transfer of Partnership Interest or Corporation Shares

FMV	ACB	Various Sale Prices to Child	Deemed Proceeds & Cost	Capital Gain
$800,000	$200,000	$800,000	$800,000	$600,000
800,000	200,000	400,000	400,000	200,000
800,000	200,000	200,000	200,000	0
800,000	200,000	100,000	200,000	0

LAND

Farmland in many cases has grown in value and contains a significant capital gain. Since parents often have the $500,000 capital gain exemption available to them the strategy is to try to transfer the land at as high a value as possible. *Table 8* above illustrates the results of different family sale prices.

FARM FAMILY PARTNERSHIPS AND CORPORATIONS

The *Income Tax Act* also provides for the deferral of tax on the transfer of an interest in a family farm partnership and shares in a family farm corporation. Like land, these capital items are subject to capital gains. The deferral mechanism permits flexibility in choosing the sale prices to a child. A value between zero and the adjusted cost base will have no tax cost. A sale between the adjusted cost base and fair market value will trigger a capital gain, the amount being dependent on the price. *Table 9* illustrates the results of alternative transfer prices. When the capital gain exemption is available it can be beneficial to sell an interest or shares at close to FMV to take advantage of the capital gains exemption and have a higher ACB for the child. This higher ACB would only be an advantage if the child sold the shares and not the individual assets. The alternative minimum tax may be a factor in some cases.

FARM BUSINESS TRANSFER EXAMPLE

From the above discussion, it is evident that various values can be used depending on the needs and desires of the family. Capital gains can be deferred or triggered, recapture deferred and the farm business transferred at a price the child can afford. While there is no single strategy that works for everyone there are some general approaches that are often used. A common strategy might be:

- transfer land between ACB and FMV. If the capital gains exemption is available the price is usually closer to the FMV
- quota is transferred at a value that does not create any recapture or gain if no exemption is available. The calculation for determining the price is (4/3 x CEC) – 1971 Value. If capital gain exemption is available then a higher value might be used.
- depreciable assets purchased before 1972 (Part XVII) are transferred at fair market value or as a gift
- personal residence is transferred at fair market value or as a gift
- depreciable assets purchased after 1971 (Part XI) are transferred at or near undepreciated capital cost (UCC)

TABLE 10. Transfer Example

Assets	ACB (UCC or CEC)[1]	FMV	Capital Gain or Recapture	Transfer Scenarios		
				A	B	C
Land	125,000	600,000	475,000	600,000	500,000	125,000
Quota [2]	100,000	575,000	475,000[2]	575,000	300,000	133,333
Buildings (Pt.XI)	60,000	200,000	140,000	200,000	60,000	60,000
Machinery (Pt.XI)	50,000	90,000	40,000	90,000	50,000	50,000
Inventory	—	50,000	—	50,000	50,000	50,000
House	30,000	90,000	60,000	90,000	—	90,000
Total	**$365,000**	**$1,605,000**	**$1,190,000**	**$1,605,000**	**$960,000**	**$508,333**

(1) UCC is the undepreciated capital cost and CEC is the cumulative eligible capital.

(2) The calculation for the deemed taxable capital gain on quota is more complex than just taking 50% of the capital gain as is the case with an asset such as land. For details refer to the Factsheet "*Taxation on the sale of Farm Assets*" Order No. 00-089. The calculation for quota is based on $40,000 depreciation, 1971 value of $0, and a CEC of $100,000.

TABLE 11. Transfer Results

Scenario	A		B		C	
Assets	Capital Gain, Recapture or Income Triggered	Potential Taxable Income	Capital Gain, Recapture or Income Triggered	Potential Taxable Income	Capital Gain, Recapture or Income Triggered	Potential Taxable Income
Land	475,000	237,500	375,000	187,500	—	—
Quota	475,000	227,500	200,000	90,000	33,333	—
Buildings –Part. XI [1]	140,000	140,000	—	—	—	—
Machinery – Part. XI [1]	40,000	40,000	—	—	—	—
Inventory	50,000	50,000	*see note 2*	—	25,000[2]	25,000
House	60,000	0	0	—	60000	0
Sub Total	**$1,240,000**	**$695,000**	**$575,000**	**$277,500**	**$118,333**	**$25,000**
Tot. Recapture & Income		270,000		40,000		25,000
Total eligible for exemption		425,000		237,500		—
Capital Gain Exemption Used	500,000	250,000	475,000	237,500	—	—
Total	$740,000	**$445,000**	$100,000	**$40,000**	$118,333	**$25,000**

(1) Buildings and machinery are Part XI and have only recapture.

(2) Inventory – in scenario B a note for inventory for the full $50,000 is used: in scenario C a note for $25,000 is used resulting in $25,000 of income in the year of transfer.

The highest transfer price that allows maximum deferrals is the combination of land at ACB, quota at (4/3 x CEC) – 1971 Value, Part XI assets at UCC, Part XVII assets at FMV and personal residence at FMV. *Tables 10 and 11* above outline this type of transfer in scenario C along with some other combinations in scenario A and B.

From the example in *Tables 10* and *Table 11* you can see that scenario B uses the 500,000 capital gains exemption which allows the assets to transfer at a higher value which gives the children a higher ACB. Land transfer tax would be payable on the actual values that the assets transferred at. If they were gifted there would be no land transfer tax.

SECTION 6 — THE CAPITAL GAINS EXEMPTION

TAXATION OF CAPITAL GAINS

One half of a capital gain is subject to regular income tax. The other portion may be subject to the alternative minimum tax. The taxable portion is added to other personal income in the year it occurs. Any allowable capital losses are first deducted against the taxable capital gains in that year.

$500,000 CAPITAL GAINS EXEMPTION

The $500,000 Capital Gains Exemption is available to individuals on the sale of qualified farm property. An

individual who used their entire $100,000 personal exemption, which was eliminated in 1994, has $400,000 remaining. The exemption is also available for partners in a partnership, since taxes are paid at the individual level. Corporations, however, do not have any exemption.

Capital gains income is taxed at the individual's tax rate. However effective October 18, 2000 only 50% of the gain is taxable. For example, a $500,000 capital gain would result in $250,000 of taxable capital gain (50% of 500,000). The use of the terms "capital gain" and "taxable capital gain" can be confusing. The capital gain refers to the total gain as calculated in *Table 12*. The $500,000 capital gains exemption is applied to this gain. The "taxable" capital gain is what you report for income tax. That is, 50% of the capital gain. A $500,000 capital gain would result in $250,000 of taxable capital gain. Your $500,000 capital gain exemption would provide an exemption for the $250,000 of taxable capital gain.

The $250,000 that is not taxable would be considered for alternative minimum tax calculations (see Section 8).

Some tax credits may be affected in the year you use your capital gain exemption. This is because capital gains are included in calculating your net income for income tax, which in turn affects the calculation of tax credits. The exemption is used just before calculating the taxable income. This increase in net income may also reduce Old Age Security and Child Tax benefits for one year following the capital gain.

CALCULATING YOUR CAPITAL GAIN

To calculate a capital gain or loss, you must know the adjusted cost base (ACB). This is the amount deducted from the selling price to determine a capital gain or loss. For property obtained before 1972, the ACB is the greater of original cost or the December 31, 1971 value. If obtained after 1971, the ACB is the purchase price plus costs. For land, the cost base is adjusted by adding any non-depreciable capital improvements, such as a new orchard. Legal and realty fees are added to the adjusted cost base. The ACB of buildings would be increased by any capital improvements or additions, beyond just the normal maintenance and repair. An example of a capital gain calculation follows:

TABLE 12. Calculating Capital Gain

Proceeds of sale	$250,000
Adjusted Cost Base (ACB) of Asset	$150,000
Selling Costs – legal and real estate fees	$10,500
Capital gain = $250,000 – ($150,000 + $10,500)	$89,500

Qualified farm property includes:

- farm land and buildings
- shares in a family farm corporation
- an interest in a family farm partnership
- quota (*referred to as eligible capital property — see page 6*)

Equipment, machinery and inventory are not eligible for the $500,000 exemption. However, in a partnership or corporation, the value of equipment, machinery and inventory can be included in the corporate shares or partnership interest.

Qualified farm property must meet the following definitions:

Property must be used in farming by the individual, the spouse, child or parent of the individual or by a family farm partnership or corporation of the individual, spouse, child or parent and

Property purchased prior to June 18, 1987:

- must be used in farming at the time of sale or
- have been used in farming for any 5 years during its ownership

Property purchased after June 17, 1987:

- must be owned for 24 months prior to the sale and
- in at least 2 years, the gross farm income must exceed net income from other sources or the property was used by a family farm partnership or corporation in a 2 year period during which time the individual, spouse, child or parent was actively involved in the farming business.

In all cases the qualifying individuals, whether farming as a sole proprietorship, a partnership or corporation, must be actively engaged in management and/or the day to day activities of the business.

Note: If you elected to use the $100,000 exemption to increase your ACB, you are deemed to have disposed of the property in 1994 and you must meet the post June 1987 rules for qualified farm property on a future sale.

SPLITTING CAPITAL GAINS BETWEEN SPOUSES

If both spouses contributed to the purchase of property, they can split the gains to reduce taxes. Although both may be on title, it is the contribution toward the purchase that is the most critical.

If a second spouse was added to title by gift, the timing is important. Spouses added to title on or before December 31, 1971 appear to qualify. However, if they were added on or after January 1, 1972, attribution rules prevent splitting. Attribution is where the gain is attributed back to the original spouse who gifted the property to the other spouse. A sale to a spouse at full value should not attract the

attribution rules on future gains, however a transaction must take place.

If the property is the asset of a spousal partnership, gains flow through to each partner based on their percentage ownership.

SECTION 7 — RESERVES AND FORGIVENESS OF DEBT

RESERVES

A more detailed discussion of reserves can be found in the OMAFRA Factsheet *"Taxation on the Sale of Farm Business Assets"* Order No. 00-089.

A reserve is a term used to describe the mechanism allowed by Revenue Canada to defer the reporting of either business income or taxable capital gains. It can be used when all or part the proceeds of the sale are not payable until after the end of the year in which the property is sold. **A reserve is not available for quota.**

A reserve is not available where a promissory note, without restrictions as to when payment can be demanded, is used to represent the unpaid balance. In this case the note represents "absolute payment" of the debt. Where a note contains restrictions, such as payable 366 days after demand, a reserve is allowed. Mortgages also qualify.

A reserve for capital gains must bring into income at least 20% of the gain per year; a gain is usually spread over no more than 5 yr. The exception is the sale of family farm property to children, which requires only 10% of the gain to be brought into income, resulting in a maximum 10 year spread of the capital gain.

WHY USE A RESERVE?

Although the $500,000 capital gains exemption is available, there are several reasons to use a reserve. The first is where a large capital gain occurs, triggering alternative minimum tax. Using a reserve spreads the gain over a number of years, reducing the possibility of paying AMT. As the capital gain is removed from the reserve, the capital gains exemption, where available, can be used. The second is to spread out capital gain income where the exemption was not available or had been used.

FORGIVENESS OF DEBT

Forgiveness of debt by a gift that reduces a note or mortgage, or one that is used to reduce indebtedness is called a debtor's gain. Such a gift can have tax consequences to the recipient. There is series of tax results in forgiving a debt including reductions in farm losses, net capital losses and restricted farm losses. If none of these is applicable then the ACB of the capital asset is reduced. If a parent wants to gift money to a child they should consult with their accountant about the best way to do that. Simply writing off of debt or an exchange of cheques should be avoided.

Forgiveness of debt in a will (by bequest) does not reduce the ACB of the beneficiary. This practice is becoming more common as parents transfer land at FMV to utilize the capital gains exemption. It also assures a stream of cash inflow to the parent(s) while they live and the child runs a successful business.

SECTION 8 — ALTERNATIVE MINIMUM TAX (AMT)

Alternative Minimum Tax (AMT) was introduced in 1986 but is still unknown to some. It is a tax on dividends from Canadian corporations and capital gains. The AMT calculation brings into income the 50% of the capital gain not normally subject to tax. Because of the changes in the capital gains inclusion rate, the amount of the gain for AMT calculation purposes is adjusted down by 20% (multiplied by 0.80). This, in conjunction with the exemption of $40,000, means that the AMT has no effect until a gain of more than $133,333 is realized. (The $133,333 gain is adjusted down to $106,666 and from that 50% of the gain, or $66,666, is subtracted, leaving $40,000 as the amount of the exemption). *Table 13* shows the impact of the AMT.

While RRSP contributions are used to reduce tax, they are not used in the calculation of the AMT. Any minimum tax paid can be carried forward up to 7 years, and used as a credit against any tax payable in those years.

TABLE 13. Alternative Minimum Tax Calculation

	Regular Tax Calculation ($)	Minimum Tax Calculation ($)
Capital Gain	200,000	
Taxable Capital Gain – 50%	100,000	
Amt of gain for AMT (.80 x 200,000		160,000 [1]
Income included after capital gains exemption used	0	
Untaxed Capital Gain (160,000 - 100,000)	0	60,000
Plus Farm Income	45,000	45,000
RRSP Contribution	0	NA
Minus Minimum Tax Exemption		40,000
Approx. Taxable Income	45,000	65,000
Approx. Federal Tax Payable [2]	6,424	9,214
Additional Min. Tax payable [3]		2,790

[1] The calculation for the alternative minimum tax adjusts the capital gain downward by multiplying the gain by .80. This is done because of the lower capital gain inclusion rate.

[2] To calculate the regular tax payable, the federal tax rates are 16% on the first 30,754, 22% on income between 30,775 and 61,509, 26% on income between 61,510 and 99,999 and 29% on income over 100,000. To calculate the federal tax payable in the minimum tax calculation the rate is a flat 16%.

[3] Only the basic personal tax credit of $7,412 has been used in the calculation of federal tax payable. The effects of other credits and CPP have not been used in this approximate calculation for the sake of simplicity. The use of these credits would further reduce the taxable income, which would reduce the federal tax payable.

This publication is intended as general information and not as specific advice concerning individual situations. Although it outlines some of the legal and tax considerations of transferring farm assets, it should not be considered as either an interpretation or complete coverage of the *Income Tax Act* or the various law effecting within family transfers. The Government of Ontario assumes no responsibility towards persons using it as such. All transfers should be discussed with your accountant and lawyer before they are undertaken.

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